Wealth Management Advisory
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Standard Chartered

Pakistan Market Outlook

State Bank of Pakistan likely to remain on course of monetary tightening in FY19. We continue our liking for short to medium tenor government bonds

From the equity perspective 2019 will be a year to prepare and react for the long run based on attractive valuations. However we remain cautious in the short run and expect the market to be range bound and volatile

We expect further PKR adjustments, as government and IMF move towards a consensus

Contents

1 Highlights

2 Asset Classes

3 Conclusion

Macro overview

Bye bye Goldilocks

- GDP growth will likely decelerate in FY19 as policies for economic stabilization will take a toll.
- We expect GDP growth in FY19 to drop below 5% vs. 5.8% in FY18.
- We believe SBP will continue to hike interest rates in FY19 and PKR will continue to slide vs. the greenback as IMF demands greater FX flexibility.
- KSE100 index has significantly underperformed in 2018 due to pre-election political uncertainty, decreasing FX reserves, delay in key policy decisions by the new government and outflow of foreign investment.

A year of macro adjustments

The new Government, led by Prime minister Imran Khan (former cricketer) has taken aggressive decisions, both on interest and exchange rates, to control the deteriorating macroeconomic environment. We expect the government to remain on this course of action until macroeconomic indicators improve significantly.

We believe the new government will possibly enter into an IMF programme for balance of payments support in H1-2019. However reforms and adjustments suggested by IMF to qualify for a possible financial arrangement may create headwinds for Pakistan's economic growth and corrective measures will probably include further fiscal and monetary tightening, including greater exchange rate flexibility.

Pakistan's economy grew by 5.8% in FY18, the highest in the last thirteen years which has led to current and fiscal deficits at all time highs. This growth was primarily driven by loose monetary and fiscal policies, activities around CPEC related projects and a period of low inflation.

It is most likely that the GDP growth for FY19 will drop below 5%. However we expect modest growth in the medium term as investments related to China-Pakistan Economic Corridor (CPEC) will support growth and boost economic activity.

The near term outlook remains gloomy as recent data suggests that large scale manufacturing may slow down, furthermore trade and fiscal deficits may also not improve drastically in FY19.

IMPLICATIONS
FOR INVESTORS

GDP growth is expected to slow down in FY19 from 5.8% in FY18 as authorities take measures for macroeconomic adjustments

IMF programme likely delayed not derailed

CPEC related projects and domestic demand will continue to positively drive the business sentiment and economic activities

The current account deficit for Q1-FY19 marginally contracted by USD 96mn or 2.5%. The Current account deficit for Q1-FY19 is USD 3.665bn, compared to USD 3.761bn in the same period of last fiscal year.

In FY18 the current account deficit widened to USD 17.9bn from USD 12bn in FY17. This inequality in Pakistan's balance-of-payments in FY18 was particularly due to the rise in global oil prices, higher consumer imports and a strong demand for capital goods (as part of the CPEC programme). Subsequently SBP FX reserves have declined to USD 7.2bn (approx 2 months of import cover) from around USD 14.1bn at the end of DEC 2017.

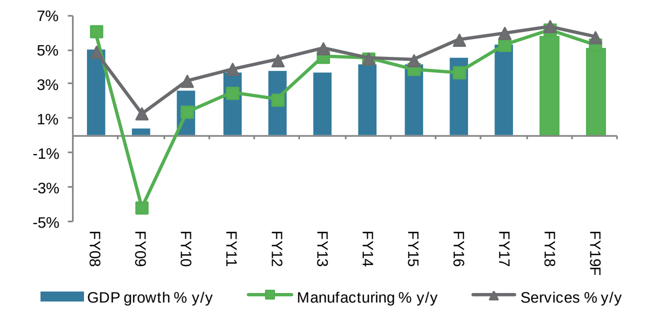
Government has already imposed higher duties on some imported and luxury items but the impact of higher duties will likely reflect in H1-2019.

The SBP has already started monetary tightening, raising interest rates by 450bps since January 2018. This has been supplemented by a PKR depreciation of approx 26%. We believe there is a high probability of SBP continuing to raise rates in H1-2019 to control aggregate demand and inflationary pressures.

Figure 1

GDP growth likely to slow down in FY19

Pakistan real GDP, manufacturing and services growth and consensus forecasts (Bloomberg consensus)



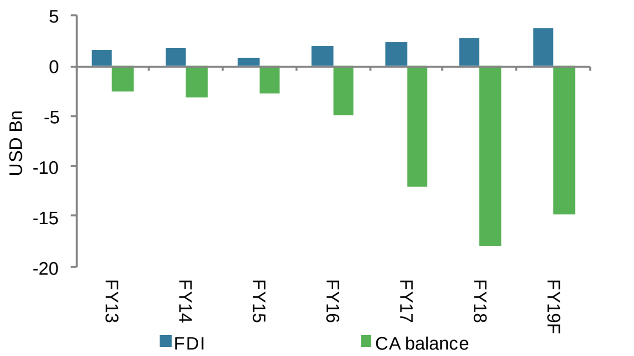
Source: PBS, SBP, Bloomberg, Standard Chartered

Pakistan's fiscal deficit remains elevated and is a key risk. The fiscal deficit soared to 6.6% of GDP in FY18, compared to 5.8% in FY17. In Q1-2019 country's fiscal deficit rose to 1.4% of GDP compared to 1.2% in the corresponding quarter of the last fiscal year. Unless corrective steps are taken by the new government the fiscal deficit could rise further in FY19, primarily due to limited revenue growth and increase in federal and provincial spending. This is clearly an unsustainable path.

Figure 2

Balance-of-payment sustainability is the biggest concern for 2019; FDI unlikely to offset ballooning current account deficit

Foreign direct investment (FDI) and current account (CA) balance



Source: PBS, SBP, Bloomberg, IMF, Standard Chartered

To bring down the fiscal deficit to 5.1% of GDP in the ongoing financial year the new government has amended the populist budget FY19. The former ruling party PML-N had taken various populist measures in the budget including large tax breaks for the corporate sector and individuals through reduction in tax rates. However the current ruling party PTI has amended budget FY19 and in particular has cut spending on federal development programme, tax reliefs granted in the last budget have been revoked, customs and regulatory duty on some luxury and imported items has been increased.

In summary, while Pakistan's economic outlook improved in FY18, more is due in the coming months as the newly announced finance bill is expected to increase revenues, promote export oriented industry and take other fiscal measures. Despite all these initiatives we expect the growth to slow down in FY19 as the new government will likely continue to take corrective measures as needed to curtail the widening of external and fiscal deficits.

Bonds

PKR Bonds yields becoming more and more attractive

- Central bank's hawkish policy drove yields significantly higher in CY18.
- We view shorter and medium tenor bonds as preferred holdings because they yield a fixed return and are less volatile.
- Expectations of rising oil prices and a widening fiscal deficit, along with prospects for an increase in inflation are key risks to the bond markets.

Bond Tenors	View	Rates policy	Macro factors
2 Year bond	▲ Preferred	● Not Supportive	● Not Supportive
10 Year bond	▼ Less Preferred	● Not Supportive	● Not Supportive

Source: Standard Chartered Wealth Management Pakistan Investment Committee

Legend: ● Supportive ● Neutral ● Not Supportive ▲ Preferred ▼ Less Preferred ◆ Core

In our assessment PKR Bonds yields have become more and more attractive over the past year CY18 and are hard to ignore, thanks to the hawkish central bank policy. However we believe in FY19 central bank will likely slow down rate hikes as policymakers will shift focus towards supporting slowing economic growth.

Elevated fiscal deficit and mounting inflationary pressures are key risks to the bond markets. We anticipate the SBP to continue hiking rates in FY19, which makes the long-term Pakistan Investment Bonds (PIBs) our least preferred asset class. Instead, we prefer short to medium term paper or floating rate instruments in order to take advantage of or at least mitigate the impact of rising interest rates.

Inflation and Interest rates are expected to rise nominally from here although fiscal deficit will likely remain troublesome in the near future. We expect CPI inflation to rise as a result of higher import prices following the PKR's depreciation and government's decision to raise customs and regulatory duty on various imported products. We expect inflation to rise upon the back of PKR devaluation in CY18. Core inflation has accelerated to 8.7% on the back of strong domestic demand. We expect CPI inflation will rise gradually in FY19 on the back of persistent core inflation, higher oil prices and further PKR depreciation.

Country's fiscal deficit is projected around 5.3% of GDP in FY19, from 6.6% in FY18. If not managed, Budget FY19 will lead to a further widening of the deficit and higher deficit financing needs of the government may lead to rise in yield curve.

IMPLICATIONS FOR INVESTORS

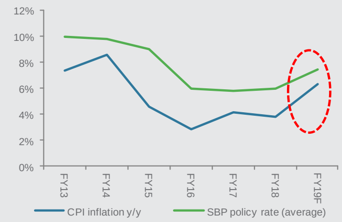
SBP likely to continue hiking rates in FY19. Currently the policy rate stands at 10.25%

We expect inflation to rise in the near term, but stay within SBP's target range of 6.5 -7.5% in FY19

Figure 3

Inflation likely to rise going forward

Pakistan CPI y/y and SBP discount rate (FY average)



Source: PBS, SBP, Bloomberg, Standard Chartered

Equities

PK Equities a year to prepare and react

- KSE100 Index has declined by 8.4% in 2018.
- Earnings growth likely to slow down in 2019, but valuations remain attractive.
- Key risks are delay in IMF bailout and CPEC related projects, political uncertainty and balance of payments issue.

Pakistan Equities – at a glance

KSE100 Index has had a second difficult year having declined by 8.4% in 2018 compared to a decline of approximately 15% in 2017. Pre & post election political uncertainty, deteriorating balance of payments, delay in IMF programme and continued foreign selling (US$ 500mn in 2018) weighed on the KSE100 index throughout the year.

In the near term, we expect the market to remain volatile until the government provides clarity on IMF facility, economic roadmap and takes initiatives to address rising trade and fiscal deficits which pose macro-economic risks.

Pakistan's meagre Index performance and PKR depreciation has eroded market capitalization of the three companies listed in the MSCI emerging market index (OGDCL, HBL and MCB). If the currency devaluation continues it is likely that Pakistan will be downgraded from Emerging to Frontier markets.

However, we believe the local equity market may recover in the long run once the IMF programme is in place and government lays out the economic plan to manage the fiscal deficit, boost growth and facilitate exchange rate stability. These steps by local authorities may also help to slow down foreign selling in 2019.

Given the current economic challenges along with higher inflation and interest rates (450bps increase in the last 12 months) are likely to slowdown corporate earnings growth in 2019. We continue our liking for E&Ps, banking and export sector which will benefit from higher oil prices, interest rate hike, PKR devaluation and government subsidies.

From the valuation perspective Pakistan equities are trading at a forward PE of 6.6x, which is at a significant discount compared to its regional peers. Alongside attractive valuations, Pakistan market is offering an attractive dividend yield of 6.4% which is highest in the region.

IMPLICATIONS
FOR INVESTORS

Local equities our preferred asset class for the long-term

Pakistan market is offering attractive dividend yield of 6.4%

Figure 4

Regional Multiples

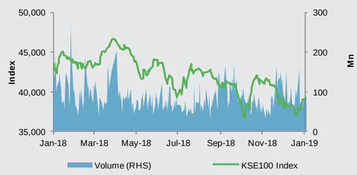
Regional Multiples		
Country	Forward PE	Dividend Yield
Pakistan	6.6	6.4%
China	8.8	3.1%
Hong Kong	9.8	3.9%
Thailand	13.5	3.3%
Japan	13.7	2.3%
Vietnam	10.7	1.8%
Philippines	14.8	1.7%
India	17.2	1.5%

Source: Bloomberg, Standard Chartered

Figure 5

KSE100 Index trading slightly above key support level

KSE100 index and Volume (RHS)



Source: Bloomberg, Standard Chartered

FX

PKR- Adjustment still on the cards

- Continued concerns over depleting FX reserves and absence of an IMF programme are likely to put PKR under pressure.
- Delay in an IMF programme, widening current account deficit, higher oil prices and declining FX reserves remain key risks to the PKR.

PKR – Adjustment still on the cards

Continuous decline in FX reserves and rising balance of payments issue has increased pressure on PKR, USD/PKR has risen by approx 26.6% to 139.8 in CY 2018 (from 110.45 in December 2017). USD/PKR has broadly remained stable around 105 from 2015 to 2017 meanwhile the authorities have used the FX reserves to defend the PKR even as oil prices rose and the trade deficit worsened.

Going forward we expect Pakistan to enter into an IMF programme in FY19, conditions are likely to include further Pakistani rupee (PKR) deprecation to address external imbalances. We assume that under a new IMF programme, policy makers will take strict measures including further PKR weakness, monetary and fiscal tightening that will likely lead to macroeconomic adjustments and curb aggregate demand pressure.

The current account deficit contracted by 4.4% in H1-FY19 to approx USD 7.98bn compared to USD 8.35bn during the same period last year. Although exports have slightly increased in H1-2019, however imports continue to widen the current account deficit with a considerable decline in FX reserves.

Import demand remains strong, driven by strong domestic demand, and capital goods imports under the CPEC projects. Similarly, rising oil prices will also keep pressure on the import bill. Thus we believe government will keep on taking strict measures to impose ban and additional regulatory duty on import of luxury items.

Senior members of the Pakistani administration have visited allies (China, UAE & Saudi Arabia) seeking bilateral financial support which has been provided to some extent. We expect FDI from China to continue as part of the CPEC projects, but this is unlikely to be sufficient enough to fill the required funding gap. As a result, there is a strong possibility of Pakistan entering into an IMF programme in 2019.

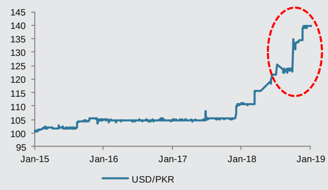
IMPLICATIONS
FOR INVESTORS

Friends of Pakistan like China, UAE and Saudi Arabia may continue to provide financial support but it may not be an alternative to an IMF programme

Figure 6

Currency devaluation amid rising balance-of-payment issues

USD/PKR spot



Source: Bloomberg, Standard Chartered

Figure 7

Foreign direct investments plunge in the first half of FY19

Chinese investments continue to lead

Source: Bloomberg, Standard Chartered

Summary

Overall, we expect 2019 to be a tough period for the Pakistan economy and government in general, given the economic risks and uncertainty on country's economic plan. A lot of the risks may have already been priced in as the KSE 100 index is trading around 40,799 level on 31st January 2019, down approx 23% from peak levels of 52,876 seen on 24th May 2017.

We believe that the local bourse will remain volatile throughout 2019. However in the second half we anticipate macroeconomic indicators to improve and support earnings growth. Specific Index heavy sectors like E&P, Banking, export and attractive valuations will possibly be a catalyst for stabilization and recovery.

We believe there is high probability of the SBP hiking rates in H1-2019, and therefore prefer short to medium maturity papers in the fixed income space. We believe, PKR has room for further weakness, as the balance of payments is likely to remain under pressure through most of 2019.

Disclosure appendix

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